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Opening Statement – Federal Communications Commission En Banc Hearing – February 12

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Opening

Good morning. I appreciate the invitation and the opportunity to share some of Wall Street's perspectives of the local television business with the Commission today. I have been actively following the broadcast business for ten years. Before becoming an equity analyst, I worked in the Media and Telecommunications Group at a commercial bank and worked extensively with television broadcasters.

When it was issued in December 1996, I read the Notice of Proposed Rulemakings with great interest, because the Commission has considerable influence over the direction and economic health of the broadcast industry. In those pages, a series of thought-provoking issues were raised addressing local ownership rules including duopoly, local marketing agreements and cross-ownership rules that are perhaps even more relevant today than when they were first written.

In my view, two central questions emerged from the NPRM. First, what is the real world relationship between ownership concentration and programming diversity in local broadcast television? Second, how does the Commission ensure that that local, free over-the-air television remains vibrant in an increasingly competitive, multi-channel world?

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With these two questions in mind, I would like to discuss the current operating and financing environment facing local television broadcasters and review with you some of the conclusions we reached in recent research pieces and notes we have written.

Facts that Illustrate the Local Television Broadcaster's Operating Environment.

To provide you with a sense of the operating environment confronting local television broadcasters, I would like to state some basic statistics to set the stage.

- In 1980, there were three broadcast networks, now there are seven.
- In 1980, there were 734 commercial television stations on the air. Now there are 1,197.
- In 1980, there were 10 major pay and basic cable networks. Now there are over 60.
- In 1980, the average home had 10 viewing options available to it. In 1998, that number increased to over 50.
- In 1980, the "big three" traditional networks captured 90% of the viewing audience. Year-to-date, the "big three" networks capture only 44% of viewing.
- In 1980, the average U.S. adult was exposed to 22 hours of cable TV fare. In 1998, the average U.S. adult was exposed to 554 hours. During that same time, cable's percentage of television viewing has increased from 2% to 39%.
- In 1980, cable networks earned $53 million in advertising revenues. In 1998, cable networks garnered $8.3 billion in advertising revenues.

Clearly, the video distribution business has become progressively more competitive during the last 20 years from both a broadcast and cable perspective. However, the main beneficiary of these changes has been the viewer; there are 60% more TV stations on the air in local markets and 400% more viewing options on a national level. There is no shortage of distinct points of view.

Operating Challenges Facing the Local Broadcasters.

In May 1998, we wrote an industry piece entitled "Seizing Control of Their Destiny", in which we identified five operating challenges confronting the television business.

The first challenge is fragmenting viewership. As cable penetration rises and new cable and broadcast networks enter the fray, local broadcasters' share of viewership is declining. Declining viewership impacts local broadcasters' revenue and expense lines simultaneously, impacting station profitability. While pressure on advertising rates impedes revenue growth, station's spending on news and national "marquee" programming has been increasing as stations struggle to differentiate themselves from video competition.

The second challenge for local station operators is battling the cable networks. Cable networks enjoy several advantages relative to local TV broadcasters. For instance, cable networks participate in a dual advertising-subscription revenue stream. Also, cable networks rely on the economics of national reach, while local television stations rely on individual markets. Additionally, while large entertainment and broadcast companies are able to "amortize" expensive programming over several broadcast and cable "windows" (i.e. channels), local stations enjoy no such opportunity. Lastly, with the inability to control both content and distribution assets, local broadcasters have no presence in the cable network business; the broadcast networks control 17 of the top 20 rated cable networks in the U.S. It is becoming progressively more difficult for a single-channel local market broadcaster to compete for advertising, programming, viewers and talent against these larger multi-channel operators.

The third challenge for the local stations is the network-affiliate relationship, which seems unusually strained. Networks, while trying to improve returns on their substantial investments in programming, would like to "repurpose" programming, while local broadcasters wish to protect valuable "brand" franchises. In the next affiliation renewal cycle, we believe that the networks, in search of profitability, will seek to substantially reduce, if not eliminate $400 to $600 million in network compensation payments they currently pay to affiliates.

The fourth challenge is a decline of national advertising in the broadcast television business. Competition for national advertising is intense as cable networks, new broadcast networks, a consolidating radio business, a consolidating outdoor business, the internet players and traditional media all compete vigorously for ad dollars. Since 1980, local television stations' share of national advertising has fallen by nearly 6%.

The fifth challenge is digital television. While questions concerning the viability of the transmission standard, the rate of consumer adoption and digital must-carry abound, the average television operator is faced with spending millions to convert stations to digital technology with no expectation that they will earn any incremental return on their investment.

The facts and challenges we just raised provide strong evidence that the local free over the air broadcast television is becoming a progressively more difficult business. The environment is even more difficult for unaffiliated stations, newer entrants and undeveloped properties.

Financial Challenges Facing the Local Broadcasters.

Now I would like to turn to the financial markets from both a company and investor perspective. Faced with a difficult operating environment, many broadcasters have had to decide whether to get bigger or get out. Since 1990, we believe that 90 licensees have elected to exit the local television business. We believe most elected to leave the business because they could not reach critical scale. For those that have decidod to consolidate the business, access to capital is crucial.

In the aforementioned industry piece, we identified four factors on which we believed television broadcasters needed to concentrate; distribution, delivery, diversity and a dual-media presence. We suggested that companies that were committed to the television broadcast business should a) have a broad distribution base, b) have the ability to deliver large audiences and/or attractive demographics, c) have geographic, affiliation and revenue diversity among its properties and d) have a multi-media presence in its markets, if possible.

It comes as no surprise that many of the factors I have cited require scale, which means industry consolidators must have acquisition capacity, which in turn means they must have debt capacity, a valuable stock currency or both. However, consolidators of television have actually paid a price to get larger; relative to other media, such as cable, radio and outdoor, television companies, on average, are more levered and television broadcast equities have not kept pace with other media. In fact, since the passage of the Telecommunications Act of 1996, the S&P 500, our Bear Stearns' cable stock index and our radio stock index outpaced our TV stock index by 18%, 102% and 207% respectively. In fact, while cable and radio company's stocks have recovered most of their retreat from October 1998's market correction, television stocks, on average, are still off 52-week highs by over 33%.

As a course of my job as an equity analyst, I meet with and talk to hundreds of portfolio managers and analysts at mutual funds who actively purchase broadcast stocks and who each influence the investment of billions of dollars. In general, I believe that these portfolio managers and analysts are "agnostics"; they are willing to own the securities of any company (broadcast or not) that exhibits predictable and sustainable cash flow and avoid those that do not. Specifically, we believe that forced divestitures of television

LMAs or radio properties will lead to a sell-off in the stocks of companies affected. Conversely, the elimination of the "one-to-a-market" rule, permanently "grandfathering LMAs" or permitting some rational form of duopoly would remove risks that confront the industry and increase the flow of capital into the industry, thus increasing broadcaster's access to the capital markets.

The Commitment to Local Free-Over-the-Air TV.

Ultimately, a strong network and local station business is essential for the survival of free over the air television and democracy. On a local level, television is one of the most important links to a particular community. Let's not lose cite of the fact that the CBS network, for example, spends $3 billion in programming and that local television stations in the top 50 markets spend over $1 billion producing local news.

Mr. Chairman, in a recent interview with Charlie Rose you said that "more and more product is migrating to cable and the subscription services. And so we're challenged, as policy makers, to assess whether this is a threat to free, over-the-air television, as we have known it, and that's going to be one of the great policy questions that is going to be debated over the next few years."

I agree with your statement wholeheartedly and would like to contribute my "few cents worth" to the policy debate on local ownership. As the business and financial environment becomes progressively more difficult, and the local, over-the-air TV model is feeling some stress, the desire to add more viewership choice and perspective in local markets remains a challenge. But this challenge is not insurmountable.

Duopoly, Local Marketing Agreements and Cross-Ownership Rules.

We support relaxation of local ownership rules because we believe that it simultaneously creates a stronger television business and more viewership choices.

We have written two research pieces on local television rules, "Will Choices Outweigh the Voices" and "LMAze". In the first piece, we tried to answer the hypothetical question, "When it comes to duopoly or LMAs, should the FCC be more concerned with increasing viewership choices or increasing ownership concentration?" Interestingly, we concluded that the average LMA simultaneously increased viewership choice and did not diminish competition in a local market.

To date, LMAs have proliferated in smaller television markets as the newer broadcast networks, WB and UPN, which were launched in January 1995, pressed to find affiliates. In fact, 80% of LMAs are in television markets 25 and below. Confronted with high costs of entry, smaller television markets, with smaller advertising dollar bases, have difficulty supporting more than a few viable television properties. In smaller television markets, we believe that combinations, like LMAs, actually encourage more viewership choices because one stronger player can subsidize the launch, operating losses, and development of another station that would arguably lack the financial capacity to be relevant in the local TV market on its own. With economic support, LMAed stations have been able to air higher quality programming, add news programming and to affiliate with emerging networks; 80% of LMA's are affiliates of the WB and UPN networks.

We also believe that the average LMA does not alter the balance of competition in local television markets. We examined the 63 marketing agreements in the top 100 U.S. markets and believe that the average LMAed station captured only 4.6% and 3.3% of the revenue and viewership share, respectively, of a local market in 1997. The typical combined revenue shares of the LMAing and LMAed stations approximate 21%, far below the revenue shares cited by the Department of Justice in its review of radio deals.

While the Commission does propose to take a first step in creating "duopolies" by permitting out-of-market Grade B signal overlaps, we believe that this step is too conservative relative to the changes confronting the television business. First, we believe that the Commission should expand the duopoly concept to permit out-of-DMA (designated marketing area) duopoly generally. We believe that television markets and the economies contained within a particular DMA are distinct.

Second, we believe that the Commission should consider permitting duopoly. Large television markets already have the most broadcast and cable viewership choices and also have the most undeveloped stations. In smaller markets, we also see no reason not to permit duopolies which help put a station on the air or strengthen the position of weaker players. That essentially is the role that LMA's currently play.

Regarding the one-to-a-market rule, we take guidance provided by the Department of Justice in its determination of whether to consider radio a distinct business from television. In a speech given by Joel Klein at the ANA Hotel in Washington, D.C. in February 1997, Mr. Klein noted that "The peak audience for radio is during the morning drive time while the peak viewing audience for television is during evening prime time. The demographics of the audience is also different, with radio stations tending to be much more focused in their demographic appeal." In reaching his conclusion, Mr. Klein also noted that "our view of radio as a distinct market does not mean that there are no advertisers who can divert their advertising to other media to avoid a price hike, but only that such behavior will not ultimately defeat an anticompetitive price increase." Ultimately, advertisers can not simply substitute radio advertising for other media in a market. If radio is a distinct marketplace in its own right, then the one-to-a-market rule is moot in terms of economic competition.

Lastly, we would encourage the FCC not to force divestitures of properties as part of a ruling on LMAs and the one-to-a-market rule. As I eluded to earlier, the stock and debt markets look for changes in the prospects of a businesses to trigger buying and selling of stocks or to determine whether to lend, or not lend to, a particular company. If LMAs were forced to be divested, we estimate that 12 public companies and at least another dozen private companies could be harmed in the form of lower valuations and tighter access to capital. Additionally, in terms of the one-to-a-market rule, we believe that if the FCC forces divestitures, it would have a significant impact on nearly a half dozen public companies and force the FCC to "unwind" portions of approximately 33 of its last 50 waivers. The debt and equity markets do not like uncertainty or economic distress, and these types of moves would create that.

In summary, I have tried to suggest to you that the operating and financial markets for local television broadcasters are difficult, that local free over the air television is a critical component of the video marketplace and that LMAs (duopolies), in general, have been important in the development of new television entrants without affecting local competition. We support the relaxation of ownership rules, including permitting LMAs and duopoly and the repeal of the one-to-a-market rule. I thank you for your time and look forward to your comments and questions.